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June 23, 1994

JUN 23 1994

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

Ex Parte

Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
Room 222  
1919 M Street, NW  
Washington, DC 20554

RE: CC Docket Nos. 93-193 and 93-179 ✓

Dear Mr. Caton:

The attached material is a written ex parte addressed to Mr. R. Metzger, Chief-Common Carrier Bureau, and members of his staff.

Any questions on this matter should be directed to me at either the address or the telephone number shown above.

Sincerely,

*Kenn. Rust*

cc: R. Metzger  
K.A. Levitz  
D. Nall  
G.P. Vaughan  
K.P. Moran

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

Mr. A. Richard Metzger, Jr.  
Acting Chief, Common Carrier Bureau  
Federal Communications Commission  
1919 M Street, NW  
Room 500  
Washington, DC 20554

Dear Mr. Metzger:

On June 2, 1994, we met with you and members of your staff to present our position on the application of "add-back" to sharing and lower formula adjustment amounts. Since that time, we have reviewed the written *ex parte* material presented on the same date by the consortium of LEC companies who disagree with our position. We have also considered some of the observations that you raised during our meeting. By this letter, we are providing you and your staff with our response to the joint LEC *ex parte* materials. We are also including an analysis of certain workpapers that Bell Atlantic filed in Docket 93-179 that may help clarify the way that add-back operates. The material is organized as follows:

**Exhibit 1.** Rebuttal to the "Add-Back Overview" On Page 2 of the June 2, 1994 Joint LEC *ex parte* submission. This provides a point-by-point response to the arguments that were made against add-back.

**Exhibit 2.** Comments on the Illustrative Example shown on page 5 of the June 2, 1994 Joint LEC *ex parte* submission. These comments demonstrate that the correct amount of sharing as intended in the Price Cap rules can only be achieved by making out-of-period adjustments for sharing.

**Exhibit 3.** Comments On The "Analysis of Add Back" on page 8 of the June 2, 1994 *ex parte* submission. These coments demonstrate that if recognition is given to the exogenous adjustments for both



sharing and the reversal of the sharing amounts, earnings are consistent with the intent of the Price Cap rules.

**Exhibit 4.** Rebuttal to arguments that add-back of sharing results in sharing beyond one year. This paper addresses Bell Atlantic Workpapers 1-1 and 1-2 in Docket 93-179.

**Exhibit 5.** Rebuttal to Workpaper 1-2 of Bell Atlantic Comments in Docket 93-179. This paper takes an alternative approach to Bell Atlantic Workpaper 1-2 to demonstrate that variables other than sharing must be kept constant in order to demonstrate the validity of adjusting for out-of-period sharing adjustments.

Sincerely,

A handwritten signature in black ink, appearing to read "Ken Rust". The signature is fluid and cursive, with the first name "Ken" and last name "Rust" clearly distinguishable.

cc: K.A. Levitz  
D. Nall  
G.P. Vaughan  
K.P. Moran

## EXHIBIT 1

### NYNEX RESPONSE TO JOINT LEC “ADD-BACK OVERVIEW”

The Price Cap Orders Contain No Provisions That Changed The Rules Requiring The LECs To Report “Earned” Revenues In Their Form 492 Rate Of Return Reports By Making Out-Of-Period Adjustments

Add-Back Is Necessary To Produce The Amount Of Sharing Intended By The Price Cap Rules And To Produce Rates Of Return Within The Upper And Lower Limits Set Forth In The LEC Price Cap Order

Add-Back Does Not “Replicate The Commission’s Earlier Rate Of Return Refund Provisions.” It Is Completely Consistent With The Letter And The Spirit Of The Sharing And Lower Formula Adjustment Mechanisms

Add-Back Is Not Designed To Address The “Lag In Returning The Benefit Of The Sharing To Customers.” It Is Designed To Produce The Correct Amount Of Sharing Or Lower Formula Adjustment In Subsequent Years.

Add-Back Cannot Be Applied Only On A Prospective Basis. It Is Already Required By The Commission’s Rules On How To Calculate The “Earned” Rate Of Return In The Form 492 Report. The FCC Acknowledged This Point In Its Notice Of Proposed Rulemaking In Docket No. 93-179, Where It Stated That Its Proposed Rule Changes On Add-Back Would Merely “Clarify” Its Existing Rules

The Fact That The Sharing And Lower Formula Adjustment Mechanisms Should And Will Be Addressed In The Price Cap Comprehensive Review Does Not Mean That The Existing Requirement For Add-Back Can Be Ignored

Each Year's Revenues Must Be Determined As Earned, Independent Of Any Influences Such As Revenues Adjusted As Mandated By The Price Cap Order Due To Earnings In Prior Periods.

NYNEX Has Demonstrated That Without The Add Back, Companies Will Earn Above The 14.25% In Every Year Following The Initial Sharing, If The First Year's Earnings Were 16.25% Or Greater. The Commission Did Not Intend That This Would Occur Under Existing Price Cap Rules

Opponents Of Add-Back Fail To Address The Fact, Without Add-Back, Customers Would Experience Prices Increases In The 3rd Year Even Though Nothing Happened To

The Cost Of Service. This Occurs Because The Booked Rate Of Return In Year 2, After Sharing, Results In Less Sharing In Year 3, And The Reversal Of Year 2 Sharing Amounts Causes Rate Levels To Increase

A Company That Earns 16.25% In Year 1 Should Share An Amount Necessary To Limit Its Booked Rate Of Return In Subsequent Years To 14.25%. Without Add-Back, If Nothing Else Happens, Prices Should Not Rise Again After Meeting Sharing Obligation. Normalizing Earnings Via Add Back Prevents Any Price Increase Since Nothing Changed

FCC, For Clarification Purposes, Should Amend Form 492 To Set Forth The Calculations That The LECs Should Perform To Add-Back Sharing Revenues And To Remove Lower Formula Adjustment Revenues

## **EXHIBIT 2**

### **NYNEX Reply to June 2, 1994 *Ex Parte* by Joint LECs - Illustrative Examples, Page 5**

In the "Illustrative Examples" on page 5 of the June 2, 1994 ex parte submission, the Joint LECs try to show that add-back improperly extends sharing beyond the one-year adjustment intended by the Price Cap rules. However, the examples rely upon faulty methodologies and improper assumptions. If add-back is applied correctly, each sharing amount is a one-time adjustment and the LEC shares the amount of revenues intended by the Price Cap rules.

#### **BACKGROUND:**

**Intent of Price Caps Sharing: Ratepayers and LEC Share Equally In Each Year's Earnings Between 12.25% and 16.25% (assuming 3.3% productivity offset factor).**

1. Any analysis of the addback issues for Sharing/LFA under Price Caps should hold all other variables constant in order to demonstrate the principles for calculating earnings in successive years.
2. Given that other variables are held constant, if the first year under price caps results in an achieved rate of return above 12.25%, all successive years will by definition have returns above 12.25% for purposes of computing sharing.
3. The achieved rate of return after sharing must be at the mid point of the range between 12.25% and the earned rate of return for sharing purposes, in each year. This is what the commission intended by definition of the one time sharing adjustment.
4. The mechanism for achieving the Price Caps sharing goals are in the existing rules for completing the Form 492A.

#### **Comments on the Illustrative Example on page 5 of Joint LEC *ex parte*:**

**The "Without Add-Back of Sharing" section does not hold other variables constant:**

This section shows a rate of return of 12.14% for years 3, 4, and 5. The reason, however, is obvious. Although the revenues line is adjusted downward to reflect sharing in years 2 and Year 3, it fails to reflect the fact that sharing is limited to a one time exogenous adjustment. The Year 3 revenues should have reflected the upward exogenous adjustment

to cancel the prior year's sharing. The same is true for Years 4 and 5. It is odd that the upward adjustment to end the one-time sharing is ignored since the basis of the ex parte example is to demonstrate that sharing is a single year's one-time adjustment. A further computational complication is that the Year 3 Expenses and Taxes increased from \$2,090 to \$2,096 even though revenues shown decreased from \$2,630 to \$2,618. Examples that are intended to illustrate the add back issue must hold variables constant, other than the sharing/LFA adjustments. This example, if not corrected, does not prove anything.

The “Without Add-Back of Sharing” section, if revised to hold other variables constant, shows that the achieved rate of return will stay above the mid point range after sharing each year if add-back is not applied:

In the attached chart, NYNEX has corrected the “without add-back of sharing” illustrative example by holding all other variables constant. In addition, for years 3, 4 and 5, NYNEX has applied sharing as a one year adjustment (i.e., we reversed the previous year’s sharing amount each year). Note that the Year 2 one-time sharing of \$25, due to the earned return of 12.90% in Year 1, results in an achieved return in Year 2 of 12.57%, which is the midpoint between 12.25% and 12.90%. This is the correct rate of return if the LEC is sharing half of its earnings above 12.25%. Since all other variables are held constant, the company should continue earning the Year 2 achieved return in subsequent years. However, without add-back, the rate of return in each of the succeeding years will remain significantly above 12.57%, which means that the LEC is not sharing half of its earnings above 12.25%. As shown, in the third year and thereafter, the rate of returns will be somewhere between 12.75% and 12.65%. Without adjusting each years' booked revenues to remove the effects of prior years' sharing (add back mechanism), earnings for price caps sharing purposes will be understated. Thus, as shown in Years 3, 4 and 5, prices will increase even though the carrier’s underlying performance did not change after Year 2.

The “With Add-Back of Sharing” section, correctly calculates the sharing amounts, but does not reflect the achieved rate of return for shareholders:

This example correctly calculates the sharing amounts when all other variables are held constant, but it miscalculates the rate of return achieved by shareholders. Although booked revenues are correctly stated in years 2 through 5 as being reduced by sharing, and although sharing amounts are properly added back to the earned revenues on the third line (labeled “adjusted revenues with add back” in the Joint LEC example), the rate of return of 12.90% is only the rate of return used for calculating the next year’s sharing amount. The actual rate of return the the LEC will experience will be 12.57% each year after year 1. This is as the Commission intended in the Price Cap rules, because it is precisely half the difference between 12.25% and the 12.90% earned rate of return. This example does not prove that addback extends sharing beyond a single year. It simply proves that with all other factors held constant, prices should not increase once the company and customers are sharing equally in the earnings above 12.25%. This earnings result can only be

achieved if each year's earnings computation on the Form 492 for sharing purposes is adjusted to remove the effects of the prior year's sharing through add-back.

## Illustrative Examples

### Without Add Back of Sharing

	<u>Yr 1</u>	<u>Yr 2</u>	<u>Yr 3</u>	<u>Yr 4</u>	<u>Yr 5</u>
Earned Revenues	\$2,655	2,630	2,618,2643	2,618,1637	2,618,2641
Expenses and Taxes	2,100	2,090,2089	2,096,2095	2,096,2093	2,096,2091
Net Income	555	540,541	522,548	522,544	522,546
Rate Base	4,300	4,300	4,300	4,300	4,300
<i>Achieved</i> Rate of Return & ROR for sharing calculation purposes	12.90%	12.57%	12.75%	12.65%	12.70%
Price Cap 50% Sharing Based on Previous Year's ROR	--	(\$25)	(\$12)	\$0 (+/8)	\$0 (+/4)

### With Add Back of Sharing

	<u>Yr 1</u>	<u>Yr 2</u>	<u>Yr 3</u>	<u>Yr 4</u>	<u>Yr 5</u>
Earned Revenues	\$2,655	2,630	2,630	2,630	2,630
Add Back of Sharing - <i>out of period adjmt.</i>	0	25	25	25	25
Adjusted Revenues with Add Back	2,655	2,655	2,655	2,655	2,655
Expenses and taxes	2,100	2,100	2,100	2,100	2,100
Net Income	555	555	555	555	555
Rate Base	4,300	4,300	4,300	4,300	4,300
Rate of Return - <i>FOR SHARING</i> <i>CALCULATION PURPOSES</i>	12.90%	12.90%	12.90%	12.90%	12.90%
Price Cap 50% Sharing Based on Previous Year's ROR including Add Back of Sharing	--	(\$25)	(\$25)	(\$25)	(\$25)
<i>Achieved Rate of Return</i>	12.90%	12.57%	12.57%	12.57%	12.57%

### **Add Back Extends Sharing Beyond Being A Single Year's One-Time Adjustment**

\* Add back results in achieved earnings at the midpoint between 12.25% and each year's earned return.

### EXHIBIT 3

#### COMMENTS ON THE EX PARTE "ANALYSIS OF ADD BACK"

In the "Analysis of Add Back" on pages 8-12 of the June 2, 1994 Ex Parte filed by the joint LECs, the discussion of ROR with Add Back (Exhibit 1) states that "With Add Back, a fictitious \$20M would be added to net income for a total of \$40M over the Sharing Level resulting in another Sharing amount of \$20M to be reflected in price reductions for BY+2." The analysis neglects to state that in Base Year+2 there is also a reversal of sharing that was made in Base Year+1. Therefore the sharing made in Base Year +1 is a one time adjustment that is reversed out at the end of a year. The \$20M that is "Added back" is therefore not a fictitious amount, but rather the amount that must be added to revenues to show the Company's true operating condition for the reporting period. The add back correctly normalizes revenues so that sharing is based on revenues earned in the reporting period. With everything held constant, the revenues and expenses for each individual year would generate a net income equal to the Base Year, and therefore a sharing obligation equal to the base year. There is no continuous or permanent effect to the sharing adjustment - the sharing is a one year adjustment that is reversed out of indices at the end of the year.

The analysis "Without Addback (Exhibit 2)" therefore does nothing more than show that the company does not share the full amount that is intended under the current price cap rules. Also, if nothing changes under this example (revenues, expenses, demand held constant) then why are prices increased after Base Year +1? If everything is held constant, then the earnings on which to base sharing should be constant, and the sharing amount for each year should be constant.

The rate of return example does not provide any additional support for the argument that sharing is a permanent effect, and in fact the rate of return example could be carried forward to show that in BY+2 there should be an upward adjustment on rates to retarget them to the authorized rate of return. The effect of this adjustment is similar to the reversal of sharing at the end of the year.

NYNEX agrees that sharing reduces the incentive of LECs to invest and improve efficiencies to increase earnings, and have included such comments in the CC Docket 94-1 proceeding concerning review of the LEC Price Cap plan. In our comments NYNEX urged the Commission to eliminate the sharing and low-end adjustment mechanism from the price cap plan. The issue at hand, however, is how rate of return and sharing adjustments should be calculated under the existing LEC Price Cap plan, and the existing Form 492A reporting requirements. Under existing requirements, add back must be included to correctly calculate rate of return and sharing requirements.

## EXHIBIT 4

### ARGUMENTS THAT "ADDBACK" OF SHARING RESULTS IN SHARING BEYOND ONE YEAR ARE INCORRECT

In their comments in the CC Docket 93-179 proceeding, Bell Atlantic attached workpapers to support their argument that add-back of sharing can cause a single year's sharing to impact a company year after year. In Workpapers 1-1, and 1-2, attached, Bell Atlantic included an example that was stated to show the effect on rate of return over a five year period, with and without add back of sharing adjustments.

In Workpaper 1-1, the example without addback of sharing indicated a rate of return (ROR) of 12.90% in year one, with a sharing adjustment of \$23, and rates of return of 12.25% in years 2 through 5. The revenues decrease from \$2,616 to \$2,590 from Year 1 to Years 2 through 5, without explanation; and Expenses/Taxes and Investment are held constant. It appears that Bell Atlantic is making the assumption that Year 1 generates a rate of return to incur sharing, and in Years 2 through 5 revenues decrease to the point where the return is at 12.25%.

In Workpaper 1-2 Bell Atlantic includes what they refer to as addback of sharing. In Year 2 the Addback amount after taxes is \$7. The revenues remain at \$2,616 in Year 1, and \$2,590 in Years 2 through 5, prior to addback.

The analysis presented by the Bell Atlantic example is misleading in its conclusion. First, the rates of return appear fixed at 12.25% prior to addback, and then including an addback adjustment obviously raises the return over 12.25%. The analysis does not show an explicit subtraction for the sharing adjustment, however, nor does it show an addition for the reversal of sharing, since sharing is a one time adjustment.

Workpaper A, attached, shows the results on rate of return and sharing when corrections are made to the Bell Atlantic example. In the corrected example, Year 1 generates a ROR of 12.90% and sharing of \$23. Since the after tax effect of sharing is \$7 for the following calendar year (according to the Bell Atlantic Workpaper 1-2), this amount will be used to adjust revenues in Year 2, with no change to Expenses and Taxes - this has the same effect as adjusting net income which Bell Atlantic does. When all of the adjustments are made, however, including a 1. subtraction of revenues for sharing; 2. addback of revenues to calculate earned revenues for the reporting period; and 3. addition to revenues for reversal of sharing, the attachment shows there is no multiple year effect of Year One's sharing. Again, since the \$7 represents an after tax adjustment, adjustments are shown to revenues, with no change to expenses and taxes, to produce the appropriate impact on rate of return.

The Year 2 revenues are reduced by the sharing adjustment of \$7, and an addback addition to revenues of \$7 is made, to arrive at a rate of return of 12.25% for calculating the next year's sharing. In Year 3, the revenues are \$2,583 (end of year net revenues

from Year 2 - after sharing) and an additional \$7 sharing adjustment reduces revenues to complete the tariff year effect of the sharing from Year 1. However, the **sharing made in Year 2 is reversed**, and finally an addback adjustment of \$7 is included to arrive at the return of 12.25% for calculating sharing for the next year. Year 4 starts with revenues of \$2,583 (end of year net revenues from Year 3) and there is a reversal of sharing made in Year 3. As shown on the attached, the return in Years 2 through 5 is 12.25%, and therefore there is no sharing adjustment for those years, and no multiple year effect of sharing from Year One.

Another way of viewing the addback issue and the fact that sharing is a one time adjustment is to view sharing as similar to a refund, with the adjustment being completed in the year that generated the sharing obligation. This example was presented in the Notice of Proposed Rulemaking in Appendix A, and a similar example is attached (Attachment B). The example shows that the same effect is achieved with addback, that is achieved with completing the sharing adjustment within the calendar year that generated the sharing. This comparison demonstrates that addback has a single year's effect. The effect is to correctly normalize revenues in the earnings period in order to develop sharing or lower formula adjustments for the next period. Just as completing sharing in a single year (similar to a refund) has a **single year's effect** on the earning's period, addback produces the same result demonstrating it too has a single year's effect on the earnings period.

## WITHOUT ADD BACK OF PRICE CAP SHARING

		(Millions)					
Line	ITEM	Sources	Year 1	Year 2	Year 3	Year 4	Year 5
			(A)	(B)	(C)	(D)	(E)
<b>FORM 492A</b>							
1.	Total Revenues	APIs=PCIs	2,616	2,590	2,590	2,590	2,590
2.	Total Expenses and Taxes	Productivity - Inflation = 0.0%	2,100	2,100	2,100	2,100	2,100
3.	Operating Income (Net Return)	Line 1 - Line 2	516	490	490	490	490
4.	Rate Base (Avg Net Invest)		4,000	4,000	4,000	4,000	4,000
5.	Earned Rate of Return	(Line 3 / Line 4) x 100	12.90%	12.25%	12.25%	12.25%	12.25%
<b>NO ADD BACK OF SHARING</b>							
6.	Sharing Current Calendar Year	Note 2	0	0	0	0	0
7.	Sharing (Adjusted for Taxes)	Line 6 x (1 - .38) Note 3	0	0	0	0	0
8.	Amount of Add Back of Sharing	Line 7 x -1	0	0	0	0	0
9.	Net Return (excl add back of sharing)	Line 3 + Line 8	516	490	490	490	490
10.	Rate of Return (excl add back of sharing)	(Line 9 / Line 4) x 100	12.90%	12.25%	12.25%	12.25%	12.25%
<b>CALCULATION OF SHARING</b>							
11.	Earnings Subject to 50% Sharing	[Line 4 x (Line 10 - 12.25%)] x -1	(26)	0	0	0	0
12.	50% Price Cap Sharing	Line 11 x .5	(13)	0	0	0	0
13.	Composite SIT/FIT Taxes	Line 12 x ((0.38) / (1 - 0.38))	(8)	0	0	0	0
14.	Interest at 11.25% IS Authorized ROR	(Line 12 + Line 13) x 0.1125	(2)	0	0	0	0
15.	Total Price Cap Sharing	Line 12 + Line 13 + Line 14	(23)	0	0	0	0
16.	Year 1 Amount Subject to 50% Sharing	Line 15 x 2	(46)				
17.	Cumulative Sharing without Add Back	Cumulative Sum of Line 15	(23)	(23)	(23)	(23)	(23)
18.	Cumulative % of Year 1 Amount Subject to 50% Sharing	(Line 17 / Line 16, Column A) x 100	50.00%	50.00%	50.00%	50.00%	50.00%

## Notes:

1. Assumes sharing and lower formula adjustments are effective mid-year on July 1 for a 12-month tariff period in accordance with Price Cap rules.
2. Line 6 equals zero for no add back of sharing
3. Assumes composite FIT/SIT rate equals 38.0%.

## WITH ADD BACK OF PRICE CAP SHARING

(Millions)

Line	ITEM	Sources	Year 1 (A)	Year 2 (B)	Year 3 (C)	Year 4 (D)	Year 5 (E)
<b>FORM 492A</b>							
1.	Total Revenues	APIs=PCIs	2,616	2,530	2,530	2,530	2,530
2.	Total Expenses and Taxes	Productivity - Inflation = 0.0%	2,100	2,100	2,100	2,100	2,100
3.	Operating Income (Net Return)	Line 1 - Line 2	516	490	490	490	490
4.	Rate Base (Avg Net Invest)		4,000	4,000	4,000	4,000	4,000
5.	Earned Rate of Return	$(Ln3 / Ln4) \times 100$	12.90%	12.25%	12.25%	12.25%	12.25%
<b>ADD BACK OF SHARING</b>							
6.	Sharing Current Calendar Year	Note 2	0	(12)	(15)	(8)	(7)
7.	Sharing (Adjusted for Taxes)	Line 6 x (1 - .38) Note 3	0	(7)	(9)	(5)	(4)
8.	Amount of Add Back of Sharing	Line 7 x -1	0	7	9	5	4
9.	Net Return (incl add back of sharing)	Line 3 + Line 8	516	497	499	495	494
10.	Rate of Return (incl add back of sharing)	$(Ln9 / Ln4) \times 100$	12.90%	12.43%	12.48%	12.37%	12.35%
<b>CALCULATION OF SHARING</b>							
11.	Earnings Subject to 50% Sharing	$[(Line\ 4 \times (Line\ 10 - 12.25\%))] \times -1$	(26)	(7)	(9)	(5)	(4)
12.	50% Price Cap Sharing	Line 11 x .5	(13)	(4)	(5)	(3)	(2)
13.	Composite SIT/FIT Taxes	Line 12 x $((0.38) / (1 - 0.38))$	(8)	(2)	(3)	(2)	(1)
14.	Interest at 11.25% IS Authorized ROR	$(Line\ 12 + Line\ 13) \times 0.1125$	(2)	(1)	(1)	(0)	(0)
15.	Total Price Cap Sharing	Line 12 + Line 13 + Line 14	(23)	(7)	(9)	(5)	(3)
16.	Year 1 Amount Subject to 50% Sharing	Line 15 x 2	(46)				
17.	Cumulative Sharing with Add Back	Cumulative Sum of Line 15	(23)	(30)	(39)	(44)	(47)
18.	Cumulative % of Year 1 Amount Subject to 50% Sharing	$(Line\ 17 / Line\ 16, Column\ A) \times 100$	50.00%	65.22%	84.78%	95.65%	102.17%

## Notes:

- Assumes sharing and lower formula adjustments are effective mid-year on July 1 for a 12-month tariff period in accordance with Price Cap rules
- Calculation of current calendar year sharing
  - Line 6, Col A = 0
  - Line 6, Col B = Line 16, Col A / 2
  - Line 6, Col C = Line 16 (Col A + Col B) / 2
  - Line 6, Col D = Line 16 (Col B + Col C) / 2
  - Line 6, Col E = Line 16 (Col C + Col D) / 2
- Assumes composite FIT/SIT rate equals 38.0%.

WORKPAPER A

BELL ATLANTIC EXAMPLE WITH ADDBACK OF SHARING

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
REVENUES	2616	2590	2583	2583	2590
SHARING ADJUSTMENT	0	-7	-7	0	0
REVERSAL OF SHARING	0	0	7	7	0
NET REVENUE	2616	2583	2583	2590	2590
EXPENSES	2100	2100	2100	2100	2100
NET INCOME	516	483	483	490	490
RATE BASE	4000	4000	4000	4000	4000
ROR	12.90%	12.08%	12.08%	12.25%	12.25%
ADDBACK	0	7	7	0	0
ROR W/ADDBACK	12.90%	12.25%	12.25%	12.25%	12.25%
SHARING FOR NEXT YEAR	23	0	0	0	0

- WHEN REVENUES ARE APPROPRIATELY ADJUSTED FOR SHARING, ADDBACK, AND REVERSAL OF SHARING, THEN IT IS CLEARLY DEMONSTRATED THERE IS NO MULTIPLE YEAR EFFECT OF YEAR ONE SHARING ADJUSTMENTS
- YEAR 1 REVENUES GENERATE RATE OF RETURN OF 12.90% AND SHARING  
- FROM BA WORKPAPER 1-2
- YEAR 2-5 REVENUES EQUAL BELL ATLANTIC YEAR 2-5 REVENUES SET TO  
GENERATE RETURN OF 12.25% - WORKPAPER 1-2
- SHARING ADJUSTMENT IN YEAR 2 AND YEAR 3 IS BASED ON BA EXAMPLE INCLUDED IN  
WORKPAPER 1-2 - AFTER TAX AMOUNT SHOWN ON LINE 7 OF BA WORKPAPER 1-2

# WORKPAPER B

EXAMPLE ASSUMING THAT SHARING ADJUSTMENT COULD BE IMPLEMENTED  
IN EARNINGS YEAR, SIMILAR TO REFUND

REVENUES	2425	2425	2425	2425
EXPENSES	1000	1000	1000	1000
NET INCOME	1425	1425	1425	1425
RATE BASE	10000	10000	10000	10000
ROR	14.25%	14.25%	14.25%	14.25%
SHARING	100	100	100	100
ROR AFTER SHARING	0.1325	0.1325	0.1325	0.1325

EXAMPLE WITH ADDBACK OF SHARING

REVENUES	2425	2425	2325	2325
SHARING ADJUSTMENT	0	-100	-100	-100
REVERSAL OF SHARING	0	0	100	100
NET REVENUE	2425	2325	2325	2325
EXPENSES	1000	1000	1000	1000
NET INCOME	1425	1325	1325	1325
RATE BASE	10000	10000	10000	10000
ROR	14.25%	13.25%	13.25%	13.25%
ADDBACK	0	100	100	100
ROR W/ADDBACK	14.25%	14.25%	14.25%	14.25%
SHARING FOR NEXT YEAR	100	100	100	100

- THIS EXAMPLE DEMONSTRATES THAT ADDBACK PRODUCES SAME RESULTS AS SHARING COMPLETED WITHIN THE EARNINGS YEAR
- SHARING, THEREFORE IS BASED ON UNDERLYING REVENUES AND EXPENSES FOR YEAR, ABSENT SHARING EFFECT OF PRIOR YEAR.
- THIS EXAMPLE WAS ALSO DEMONSTRATED IN THE COMMISSION'S NPRM, APPENDIX A

EXAMPLE WITHOUT ADDBACK OF SHARING

REVENUES	2425	2425	2325	2375
SHARING	0	-100	-50	-75
REVERSAL OF SHARING	0	0	100	50
NET REVENUE	2425	2325	2375	2350
EXPENSES	1000	1000	1000	1000
NET INCOME	1425	1325	1375	1350
RATE BASE	10000	10000	10000	10000
ROR	14.25%	13.25%	13.75%	13.50%
ADDBACK	0	0	0	0
ROR W/ADDBACK	14.25%	13.25%	13.75%	13.50%
SHARING FOR NEXT YEAR	100	50	75	62.5

- AS THE COMMISSION POINTED OUT IN THE NPRM, WITHOUT ADDBACK, THE COMPANY WOULD REPORT A DIFFERENT RETURN EACH YEAR, EVEN THOUGH ITS UNDERLYING COSTS DID NOT CHANGE.

## Exhibit 5

### Analysis of Bell Atlantic Comments on CC Docket 93-179, Workpaper 1-2

#### BACKGROUND:

In an analysis of the add back issue, from the customers point of view, with all things other than sharing computation being held constant, the only price change under price caps should be the amount that allows the company and customer to share in earnings in excess of 12.25%. From July 1, 1992, the first point in time for price cap revisions, the customer and the company are sharing equally in the amount above 12.25%. From this point forward, there should not be any further PCI revisions given that nothing is changing.

There is no disagreement that the add back mechanism will result in higher earnings on Workpaper 1-2. The point is that the level of earnings should be based on the recognition of current year's operations and should not be distorted by the effect of regulatory lag required to carry out the price caps sharing mandate. The analysis to prove this point must focus on the recognition of (1) achieved earnings and (2) earnings for purposes of calculating price caps sharing.

#### ADJUSTMENTS ARE NEEDED TO KEEP VARIABLES CONSTANT IF ADD BACK IS THE ISSUE TO ANALYZE:

Adjustments have been made to the Workpaper 1-2 to show that calculation of sharing with addback results in earnings that exactly reflect the FCC's intent of sharing equally in the earnings that customers are entitled to receive. It does not take a leap of faith to make this demonstration prove the point. It requires that all other factors that can distort the effect of calculating earnings for sharing purposes be held constant. Thus, while revenues may change for any reason, this event will distort the results.

Line 1, Total Revenues, have been adjusted to reflect the effect solely of sharing, following the worksheet computation. Taxes have also been adjusted to reflect the adjustments to revenues. Line 5, Booked Rate of Return, reflects the intent of the FCC's price caps sharing. The earned returns are at the mid point between the 12.25% return and the rate of return for sharing purposes, Line 10. This section, Lines 1 - 5, is categorized as Form 492A on the worksheet. However, this section is the financial results as booked and does not represent the basis for FCC Form 492A. The basis for Form 492A must be adjusted to exclude the out of period effects of sharing. That is, Lines 6 - 9 reflect the out of period sharing adjustment to normalize the current years' rate of return as shown on Line 10.

**EXOGENOUS PRICE CAPS SHARING ADJUSTMENTS REPRESENT THE ONE TIME ADJUSTMENT THAT REQUIRES TREATMENT AS AN OUT OF PERIOD ADJUSTMENT:**

In order to make more clear the content of operating revenues under price caps reporting, it may be helpful to depict the stream of revenues with exogenous adjustments for sharing that constitute the Total Revenues Booked on Line 1.

Attached is a stream of revenues depicting the operating booked revenues, Line 1 of Workpaper 1-2, with the effects of the price caps sharing exogenous decrease adjustments and the subsequent exogenous increase in price caps at the end of each sharing obligation. The revenue streams by year, are further separated by the six month periods January to June and July to December to match the timing of the tariff adjustments for the exogenous sharing adjustments under the add back methodology. In the Bell Atlantic add back workpaper 1-2, the Year 1 revenues are \$2,616 Mil. and the resulting rate of return is 12.90%. The attached revenue stream shows the revenues for both 1991 periods (Year 1) at \$1,308 Mil., each.

In 1992, Year 2, the total revenues drop from \$2,616 Mil to \$2,604 Mil, reduced by one half of the 1991 \$23 Mil. (\$2 Mil per month) of sharing obligation. This occurs as a decrease in tariff revenues starting July 1992, the first sharing period. The computation of 1992 earnings for sharing purposes will therefore require an add back of the \$12 Mil shared in 1992 since this adjustment is not an appropriate component of the Form 492 1992 earnings. The add back calculation is shown on the Bell Atlantic Workpaper 1-2.

In 1993, Year 3, the total revenues drop from \$2,604 Mil. to \$2,592 Mil. The reduction of \$12 Mil is actually the result of 3 factors during the year. First, the continuation of the 1991 sharing from Jan thru June 1992, second the exogenous cost increase in tariff revenues in July 1992 to eliminate the 1991 sharing adjustment and, third, the exogenous cost decrease in tariff revenues in July 1992 for initiation of sharing for the year 1992 earnings. The 1992 earnings calculation for price cap purposes is shown on the Year 2 column of the Bell Atlantic Workpaper 1-2 as stated above. Again, the 1993 earnings calculation for sharing purposes will also require an add back adjustment. However, this time the adjustment will be for both the sharing during the first half of the year as well as the sharing during the second half of the year.

Each year thereafter will continue to reflect annual revenues of \$2,593 Mil. as shown on the Workpaper 1-2. This level of revenues, is consistent with the intent of price caps sharing. The company and the customer have an equal share of the earnings in excess of 12.25%. The company continues to earn an achieved return of 12.57% after sharing, the mid point between the 12.25% and the earnings for price cap sharing purposes, 12.90%.

The computation of sharing, using the add back principle, is based on each individual year's earnings. It is only the use of examples with all variables held constant that produce

similar results that could inadvertently cause one to suggest that the add back extends sharing beyond being a single year's one-time adjustment.

### Reporting Earnings Principles

The principle at work in Form 492, requiring that revenues be adjusted for out of period adjustments, clearly supports the objective of price caps sharing. The company and the customer, as the examples show, have an equal share of earnings in excess of 12.25% rate of return in each year. The fact that there is a regulatory lag of 18 months before sharing is effectuated should not detract from the application of the add back principle. Each year's earnings for price cap purposes must be calculated based on the operating conditions within the reporting period. The fact that a regulatory lag has the effect of distorting current years' earnings must be addressed. The FCC Form 492 is intended to accomodate this earnings principle.

Finally, the achieved earnings of the company are the important measurement of monitoring the effectiveness of Price Caps Regulation. The achieved earnings as depicted in the Workpaper 1-2, adjusted on line 5, demonstrates that the company will earn at the midpoint that reflects the equal sharing objective.

BELL ATLANTIC

WORKPAPER 1

## WITH ADD BACK OF PRICE CAP SHARING

		(Millions)						
Line	ITEM	Sources	Year 1	Year 2	Year 3	Year 4	Year 5	
			(A)	(B)	(C)	(D)	(E)	
<b>FORM 492A</b>								
1.	Total Revenues <i>Booked</i>	APIs-PCIs	2,616	2,580	2,593	2,593	2,593	2,593
2.	Total Expenses and Taxes	Productivity - Inflation = 0.0%	2,100	2,095	2,090	2,090	2,090	2,090
3.	Operating Income (Net Return)	Line 1 - Line 2	516	485	503	503	503	503
4.	Rate Base (Avg Net Invest)		4,000	4,000	4,000	4,000	4,000	4,000
5.	<i>Booked</i> Earned Rate of Return	(Ln3 / Ln4) x 100	12.90%	12.25%	12.25%	12.25%	12.25%	12.25%
<b>ADD BACK OF SHARING</b>				12.725	12.57	12.57	12.57	12.57
6.	Sharing Current Calendar Year	Note 2	0	(12)	(23)	(23)	(23)	(23)
7.	Sharing (Adjusted for Taxes)	Line 6 x (1 - .38) Note 3	0	(7)	(13)	(13)	(13)	(13)
8.	Amount of Add Back of Sharing	Line 7 x -1	0	7	13	13	13	13
9.	Net Return (incl add back of sharing)	Line 3 + Line 8	516	497	516	516	516	516
10.	Rate of Return (incl add back of sharing) (Ln9 / Ln4) x 100		12.90%	12.40%	12.40%	12.37%	12.37%	12.37%
<i>FOR SHARING CALCULATION PURPOSES</i>				12.90	12.90	12.90	12.90	12.90
<b>CALCULATION OF SHARING</b>								
11.	Earnings Subject to 50% Sharing	[Line 4 x (Line 10 - 12.25%)] x -1	(26)	(26)	(26)	(26)	(26)	(26)
12.	50% Price Cap Sharing	Line 11 x .5	(13)	(13)	(13)	(13)	(13)	(13)
13.	Composite SIT/FTT Taxes	Line 12 x ((0.38) / (1 - 0.38))	(8)	(8)	(8)	(8)	(8)	(8)
14.	Interest at 11.25% is Authorized ROR	(Line 12 + Line 13) x 0.1125	(2)	(2)	(2)	(2)	(2)	(2)
15.	Total Price Cap Sharing	Line 12 + Line 13 + Line 14	(23)	(23)	(23)	(23)	(23)	(23)
16.	Year 1 Amount Subject to 50% Sharing	Line 15 x 2	(46)	(46)	(46)	(46)	(46)	(46)
17.	Cumulative Sharing with Add Back	Cumulative Sum of Line 15	(23)	(46)	(69)	(92)	(115)	(141)
18.	Cumulative % of Year 1 Amount Subject to 50% Sharing	(Line 17 / Line 16, Column A) x 100	50.00%	65.22%	84.78%	95.65%	102.17%	

## Notes:

- Assumes sharing and lower formula adjustments are effective mid-year on July 1 for a 12-month tariff period in accordance with Price Cap rules
- Calculation of current calendar year sharing  
 Line 6, Col A = 0  
 Line 6, Col B = Line 16, Col A / 2  
 Line 6, Col C = Line 16 (Col A + Col B) / 2  
 Line 6, Col D = Line 16 (Col B + Col C) / 2  
 Line 6, Col E = Line 16 (Col C + Col D) / 2
- Assumes composite FIT/SIT rate equals 35.0%.

# Price Caps Revenue Streams With Exogenous Adjustments For Sharing

	<u>January - June</u>	<u>July - December</u>	<u>YEAR</u>
1991	218 x 6 = 1,308	218 x 6 = 1308	1,308
			<u>1,308</u>
			<u>2,616</u>
1992	218 x 6 = 1,308	218	1,308
		- 2 Begin sharing 1991	
		216 x 6 = 1296	<u>1,296</u>
			<u>2,604</u>
1993	216 x 6 = 1,296	216	1,296
		+ 2 End Sharing 1991	
		218	
		- 2 Begin sharing 1992	
		216 x 6 = 1296	<u>1,296</u>
			<u>2,592</u>
1994	216 x 6 = 1,296	216	1,296
		+ 2 End sharing 1992	
		218	
	218 x 6 = 1,308	- 2 Begin sharing 1993	
		216 x 6 = 1296	<u>1,296</u>
			<u>2,592</u>